



## CHAPTER 19

# Internal Controls

### Introduction

This chapter provides an overview of the evolution and implementation of internal control programs at the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC). Internal controls provide management with reasonable assurance that its programs are effectively and efficiently executed; waste, fraud, and abuse and misappropriation of assets are minimized; financial statements are reliable; and compliance with the law is ensured.<sup>1</sup> From 1980 to 1994, the FDIC, the RTC, and the Federal Savings and Loan Insurance Corporation (FSLIC) resolved 2,912 failed institutions. The agencies disposed of a portfolio of assets that dwarfed those of any other public or private sector entity and undertook contracting efforts that were second only to the Department of Defense in magnitude.

With the dramatic growth in the FDIC and the RTC came an increase in their vulnerability to instances of inefficiency and ineffectiveness, as well as waste, fraud, and abuse and misappropriation of assets. As the workload and staffing expanded enormously and the operations grew in complexity, traditional FDIC internal control methodologies provided insufficient assurances. When the RTC was created as an entirely new entity, it was assigned responsibility for 262 savings and loan (S&L) conservatorships with \$115 billion in assets at its inception. If not properly controlled, the resolution of the financial institution crisis had the potential to become a crisis of its own. Accordingly, the internal control programs at the FDIC and the RTC had to be

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1. The term “reasonable assurance” is an internal control standard defined by the General Accounting Office (GAO) Standards of Internal Controls for the Federal Government (1983). Reasonable assurance is a satisfactory (not absolute) level of confidence in achieving internal control objectives and safeguarding resources, given considerations of costs, benefits, and risks.

adapted to meet the radically changing dimensions of their management responsibilities. In addition, mounting public concern over the financial institution crisis and new laws subjected virtually every aspect of the agencies' activities to outside scrutiny. Internal controls therefore played an increasingly vital role in the operations of the agencies.

From 1980 to 1994, the FDIC and the RTC encountered three major areas of high vulnerability: (1) contracting and contract management, (2) information systems, and (3) asset management and disposition. Although mistakes and problems occurred in each of the areas, the FDIC and the RTC identified and resolved them. The internal controls that were developed contributed to the FDIC's and the RTC's efforts in preventing a loss of public confidence in the two agencies.

### Changing Roles and Operational Risks of the FDIC and the RTC

Because there had been few bank failures in the 1970s, the FDIC's internal control requirements for liquidation of the banks' assets were not extensive. Between 1985 and 1992, however, 2,461 banks and S&Ls failed, an average of about one per day over a period of eight years. (See chart I.19-1.)

During the 1980s and early 1990s, sweeping legislation affected the FDIC, created the RTC, restructured the banking and S&L industries, and expanded the internal control practices of independent federal agencies. Staffing requirements also created significant demands on the FDIC and the RTC. The FDIC started the 1980s with 3,598 employees, who focused primarily on bank examinations and supervision. FDIC staffing peaked in 1992 with 15,044 employees. Although regulatory supervision of institutions continued to be a high-profile function of the FDIC, the largest staff increase occurred in the FDIC's asset management division, which went from a staff of 432 at year-end 1979 to 6,608 in mid-1993. Large staffing increases also were necessary at the RTC. Created in 1989 with the transfer of a few hundred FDIC employees as its core of technical experience and management, the RTC reached its peak staffing level at 8,614 in 1991.

In addition to managing the risks associated with such a large increase in staff, the FDIC and the RTC had to address significant risks in other areas. The agencies were responsible for acquiring the services of and overseeing thousands of private sector contractors and accounting for millions of dollars of related expenses. Moreover, resolution of the failed banks and S&Ls and liquidation of the assets of these institutions required managing sophisticated financial transactions involving millions and even billions of dollars.

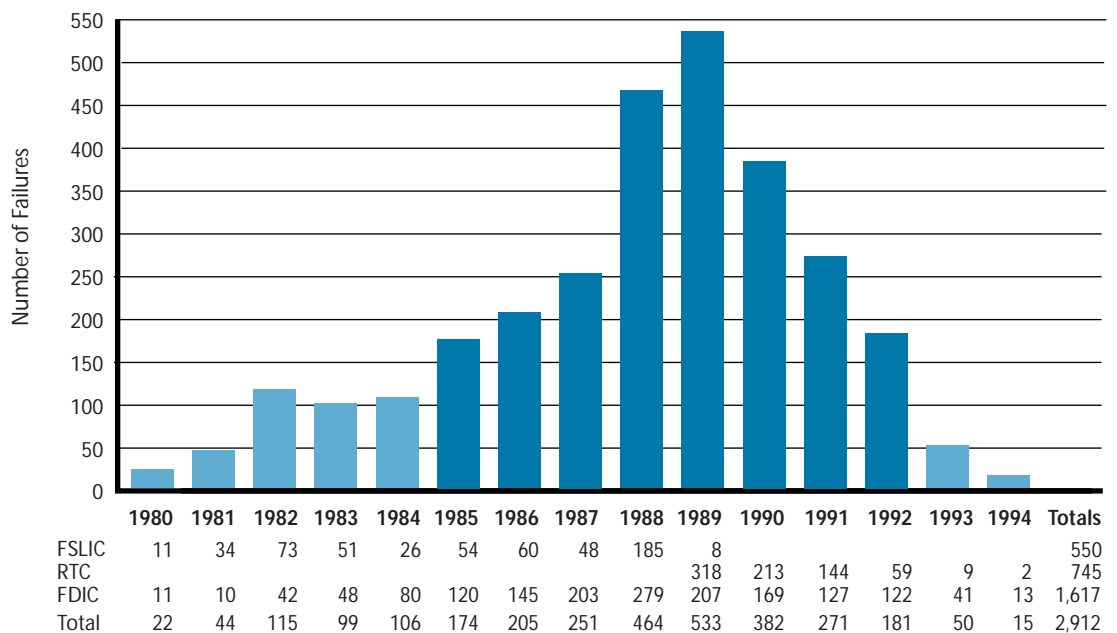
Accuracy of asset information was another key issue for the agencies. They had to expand and control their information management systems and computer resources. Merging the huge volume of financial data from each institution's system into a reliable central system of information was an especially difficult and problematic challenge. The failed banks and S&Ls used an assortment of proprietary and commercial

record-keeping systems that contained data that was difficult to assimilate into the agencies' systems.

As the workload increased, the FDIC and the RTC decentralized their asset management and liquidation operations. Beginning in 1983, the FDIC established regional and consolidated field offices in various states. At its peak, it had 23 consolidated field offices. The RTC also used a decentralized structure, which at its peak had 14 consolidated offices. As the financial crisis increased and decreased in various regions of the country, the agencies opened and closed offices. Managers of the offices were given significant delegated authority over the operations. This flexible organizational structure led to a number of innovations that proved beneficial, but made it more difficult to standardize and coordinate internal controls, policies and procedures, and information systems.

**Chart I.19-1**

**Combined Number of Failures  
(Banks and S&Ls)  
1980–1994**



Figures include FDIC and FSLIC open bank assistance transactions.

Dark blue bars represent the time frame when most failures occurred. From 1985 to 1992, a total of 2,461 banks and S&Ls failed.

Source: FDIC Division of Research and Statistics.

### Increased Performance Accountability

Throughout the financial crisis of the 1980s and early 1990s, the performance of the FDIC and especially the RTC came under the scrutiny of a wide range of public and private sector entities. The press, specialized economic interest groups, Congress, private citizens, and the General Accounting Office (GAO) all developed a heightened interest in the agencies' activities.

Government reform legislation, enacted from 1989 to 1991, elevated the FDIC's and the RTC's standards of performance accountability. First, the agencies were made subject to the provisions of the Inspector General Act of 1978, pursuant to amendments enacted in 1988.<sup>2</sup> Consequently, the FDIC and the RTC each established an Office of Inspector General (OIG) in 1989 and 1990, respectively. Second, the FDIC implemented the standards of the Chief Financial Officers Act (CFOA) of 1990. The CFOA required government corporations to submit to Congress annual management reports that included financial statements and independent audits of those statements. In addition to implementing the CFOA, the FDIC implemented the provisions of the Federal Managers Financial Integrity Act (FMFIA). Language in FMFIA reiterated the need for internal controls but, more significantly, addressed the need for federal managers to evaluate controls against GAO-established standards and required managers to report to Congress on their internal control systems and plans to correct significant weaknesses. Both the FDIC and the RTC established chief financial officer (CFO) positions and increased the independence of their internal review programs.<sup>3</sup>

In 1991 Congress passed another federal act that affected the FDIC's internal controls methodology. With the enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), the FDIC was required to describe to Congress semi-annually its efforts to maximize the use of private sector resources. Provisions in FDICIA also required management and auditor reports on the effectiveness of internal controls, independent audit committees, and accounting reforms in ensuring reliable financial reports.

In December 1992, the GAO concluded that the FDIC's Bank Insurance Fund (BIF) should be added to its list of designated high-risk areas because of the depletion of the fund and the need for improved accounting rules and bank examinations to "shore up" and maintain the well-being of the nation's system of deposit insurance.<sup>4</sup>

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2. In 1989, under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) enacted that year, the RTC was directed to comply with the 1988 amendments.

3. The RTC first established the position of CFO in January 1991 and restructured and increased the authority of the position in June 1993; the FDIC established the CFO position in November 1992.

4. GAO, Bank Insurance Fund (GAO/HR-93-3), December 1992. In 1990, the GAO began a special effort to review and report on the federal program areas considered to be high risk because they were especially vulnerable to waste, fraud, and abuse and misappropriation of assets. In December 1992, the GAO published its first reports on the fundamental causes of problems in designated high-risk series areas.

Another high-risk area the GAO identified was the RTC's management of its asset disposition and contracting activities and its information systems.<sup>5</sup> In 1989, the GAO began allocating substantial resources for monitoring the BIF and the RTC's operations. The GAO determined that the RTC, as a federal program with billions of dollars of taxpayers' money, was highly vulnerable to loss through waste, fraud, and abuse and misappropriation of assets. As a result, the GAO dramatically heightened its focus on deposit insurance regulation. When Comptroller General Charles Bowsher testified before the Senate Committee on Governmental Affairs in January 1993, he emphasized the dramatic change in focus by stating that "deposit insurance is an area where we have spent a lot of money in the last four years. It is an area we didn't spend a dime on up until fiscal year 1989."<sup>6</sup>

In 1995, because of the positive results of the initiatives by the FDIC and the RTC over a period of approximately two years, the GAO removed the BIF and the RTC from the high-risk series.<sup>7</sup> In the GAO review of the RTC's response to the management reforms mandated by the RTC Completion Act (Completion Act) of 1993, the GAO found that the RTC and the RTC Oversight Board had initiated actions to implement all the reforms.<sup>8</sup> In a later review, the GAO stated that the RTC's efforts reflected a significant commitment to implementing needed management improvements and, coupled with intervening legislation, addressed many of the identified deficiencies.<sup>9</sup>

### Accounting Industry Changes

The accounting industry's guidelines and internal controls audit methodology were also evolving during the 1980s. Traditional audit methods had focused on specific controls that failed during the audit review period and not necessarily on the overall system. Attest auditing was a traditional methodology that was appropriate to the organizational needs of the time.<sup>10</sup> Because the approach focused on historical events, however, the standards did not account for the evolving needs of the management controls of large, complex organizations. Additional pressures were on the accounting industry because some of the independent public auditors were experiencing extensive operational growth and quality control problems caused in part by efforts to meet the increased demand for their services from the FDIC, the RTC, and the banking industry.

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5. GAO, Resolution Trust Corporation (GAO/HR-93-4), December 1992.

6. *Congressional Record*, 103rd Congress, 1st sess., January 8, 1993, S. Hrg. 103-177.

7. GAO, *High Risk Series: Quick Reference Guide* (GAO/HR-95-2), February 1995.

8. GAO, *Implementation of the Management Reforms in the RTC Completion Act* (GAO/GGD-95-67), March 1995.

9. GAO, *Efforts Under Way to Address Management Weaknesses* (GAO/GGD-95-109), May 1995.

10. Attest auditing is commonly associated with a financial statement audit whereby an auditor tests the financial numbers and writes an opinion attesting to the validity of the statement.

The definition of internal controls was also being reviewed and updated during the 1980s and the 1990s. In 1983, the GAO's "Standards for Internal Controls in the Federal Government" defined internal controls as "the plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports."<sup>11</sup> The Treadway Commission, in its 1992 report, defined internal controls as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; [and] compliance with applicable laws and regulations."<sup>12</sup> As the new accounting industry procedures and standards for internal controls were being developed, the FDIC and the RTC began incorporating those controls into their operations.

### The FDIC's and the RTC's Internal Control Programs

In the 1970s and early 1980s, the FDIC's Office of Corporate Audits (OCA) used generally accepted auditing standards to conduct audits and investigations of all activities within the FDIC.<sup>13</sup> The OCA operations were designed to (1) safeguard the assets of the FDIC; (2) perform a management control function for the board of directors; (3) minimize waste, fraud, inefficiency, and excessive costs; (4) recommend improvement of fiscal and operational controls; and (5) provide information in the form of audit reports to the board of directors and management.

With the failure of Penn Square Bank, N.A., Oklahoma City, Oklahoma, in 1982 and of the Butcher-related chain of banks headquartered in Tennessee in 1983, the FDIC began to expand its control systems and internal audits to meet the growing volume and complexity of the liquidation workload. The FDIC hired independent public auditors in far greater numbers to help conduct audits. The workload of the OCA also increased. In 1984, the OCA issued 51 audit reports and, just two years later in 1986, it

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11. GAO, *Standard for Internal Controls in the Federal Government*, 1983.

12. In 1985 the American Institute of Certified Public Accountants created the Treadway Commission in response to congressional and public criticism that many of the financial institution failures were caused by the failure of the institutions' auditors to detect fraud. The commission studied the "expectation gap" between the public's and the auditors' perception of audit functions and responsibilities in distinguishing between business failure and audit failure.

13. In 1989, the OCA was designated as the FDIC's Office of Inspector General, in compliance with the 1988 amendment of the Inspector General Act of 1978. The main responsibilities of the Office of Inspector General, an independent office, are to audit the programs and operations of the FDIC and investigate complaints of waste, fraud, and abuse and misappropriation of assets. Section 5 of the amendment requires the submission of a semiannual report to Congress.

issued 157 audit reports. Thereafter, throughout the crisis years, the number of audit reports issued remained high.

In 1984, as part of enhancing internal controls, the FDIC's asset management division introduced an expanded internal visitation program aimed at providing site managers with an evaluation of their operation as well as suggestions for improvement. The visitations were designed to review all facets of division procedures and were conducted out of the headquarters or regional offices by sending FDIC staff with subject matter expertise to the office being reviewed. The program yielded returns in operating efficiencies as well as improved audit findings, especially regarding internal controls. With the increasing workload on the FDIC staff and the expansion of the review and audit programs, however, management determined that the peer-reviews were no longer sufficient or practical. In 1985, to compensate for the lack of dedicated internal review capability, the FDIC established full-time, professional internal review positions in the regional offices.

When the RTC was created with the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in August 1989, it was confronted with challenging internal control issues, such as the requirements to use outside contract services extensively and to report in great detail to the newly created RTC Oversight Board. On the RTC's first day of operation, the oversight board adopted the FDIC's procedures as an initial source of policies and procedures including internal control guidelines. Over the next 21 months, RTC management determined that the internal controls should be enhanced. In May 1991, the oversight board asked the Treasury deputy secretary and the Housing and Urban Development deputy secretary to lead a working group to direct three tasks: (1) to coordinate efforts among the board, the RTC, OIG, and the GAO to improve the RTC's management of assets, methodology to estimate asset values, cash controls, and overall internal controls; (2) to make sure that the RTC put in place an "early warning" system to identify potential problems; and (3) to ensure that the RTC had a system to track the implementation of corrective actions and to verify achievement of expected improvements.

In response to the working group's recommendations, the oversight board assigned the responsibility and oversight for RTC internal controls and security reviews of the critical financial and management systems to senior management. The board also assigned accountability for each system and its data to the program or office managers who were the primary users of the system. All department heads were responsible for evaluating their component financial subsystems. System audits included a review of general application, processing, and access security controls to ensure that data produced by a system was accurate, reliable, and safeguarded against unauthorized manipulation. In addition, the GAO and OIG conducted periodic audits of the RTC's financial and other systems.

In the early 1990s the FDIC and the RTC expanded their internal review functions. Internal review officers reviewed field offices in terms of their implementation of major programs to ensure that statutory requirements were addressed, that the programs as

designed met their objectives efficiently, and that programs and policies were being implemented and followed. They also performed internal reviews on request to address the particular needs of senior management. The FDIC integrated a risk-based internal control process to improve management controls and to satisfy the requirements of the CFOA. Risk-based internal controls are based on the accountability of management for identifying inherent risks of the operations and on the requirement that management must then develop and implement procedures and policies to reduce the consequences of any identified material risk to an acceptable level.<sup>14</sup>

The agencies' new internal review risk-based framework incorporated three additional control components into the traditional process. The first component was initiating a formalized, proactive risk management process that identified management accountability from the field level up to the headquarters level and tied the control of inherent risk to the accomplishment of program objectives. Critical controls of operational processes (event cycles) were "flowcharted" and updated on regular cycles. Tests were performed to evaluate controls for applicability and effectiveness, and corrective actions for control problems were then monitored until they were resolved. The identification and sharing of effective practices among offices contributed to the evolution of better risk management processes.

The second control component of the internal review framework was holding the chief financial officer and senior management responsible for managing weaknesses in internal controls. The third component was creating and maintaining independent management reporting systems on observed material control weaknesses. Each agency's system identified weaknesses and corrective actions to be taken and reported the status of internal controls to corporate and senior management.

In March 1992, the RTC published a directive on policies, standards, and responsibilities for the development, maintenance, and evaluation of internal controls for its programs and administrative activities. A key component of the directive required the RTC's chief executive officer to establish policies and procedures necessary for operating an RTC-wide program of internal controls. It also directed the agency to submit to its oversight board an annual statement and report on internal controls. RTC senior managers were responsible for designing, implementing, and maintaining effective internal controls within their organizations.

The FDIC also published its internal controls policies and procedures. By 1993 the FDIC had dedicated an entire office in New Jersey to the internal review of the asset management and liquidation activities.

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14. The term "inherent risk" refers to "the relative potential for fraud, waste, abuse or mismanagement due to the nature of the function of the accountability unit without regard to the control environment." FDIC, *CFOA Manual*, 1997.

## Examples of Significant Issues and Management Actions

During the 1980s and early 1990s, three major FDIC and RTC operational sectors emerged as areas of high vulnerability: (1) contracting and contract management, (2) information systems, and (3) asset management and disposition. Mistakes and problems in those areas ranged from isolated events to significant issues in major systems and program areas. For example, contracting and contract management dealt with the performance and cash management of thousands of contractors. Problems in information systems centered on the lack of consistency of data for hundreds of thousands of assets that had to be converted from a variety of systems used by the failed institutions. The asset management and disposition area focused on controls that were needed to address new techniques in the mass marketing of loans and real estate, including innovations such as securitization, national auctions, and partnerships.

### *Contracting and Contract Management*

In the area of contracting and contract management, the FDIC and the RTC were subject to statutory requirements. The RTC, as directed by provisions in FIRREA, used private sector contractors whenever practical and efficient. With the enactment of FDI-CIA in 1991, the FDIC was authorized to use the services of private sector contractors specifically for managing and disposing of assets from failed institutions when practical and efficient. Contracting and contract management were extremely important areas because contractors were used in key operational functions such as asset management and sales.

By the spring of 1990, the RTC was coming under increasing public pressure to accelerate the resolution of the conservatorship institutions. In March 1990, in response to that pressure, the RTC announced that it would liquidate 141 conservatorship institutions by June 30, 1990, and that the initiative would be known as Operation Clean Sweep (Clean Sweep).<sup>15</sup>

Clean Sweep exceeded the goal of 141 resolutions; the RTC resolved 155 failed S&Ls in 31 states with total assets of \$44.4 billion. The closings, however, had been done so quickly that inadequate consideration had been given to coordinating the records and accounting systems at the institutions being closed with the systems in place at the RTC. As of March 1991, the records and the general ledger of RTC's western region were out of balance by \$7 billion, and without an accurate accounting of the number of assets and their value, the assets could not be properly marketed.

Clean Sweep's accounting problems received extensive press coverage and criticism. In response, the RTC's western regional office quickly initiated a reconciliation project and contracted with a large accounting firm for assistance. The project to reconcile the

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15. See Chapter 4, Evolution of the RTC's Resolution Practices.

systems was called the Asset Stratification and Reconciliation Project, which became known as Western Storm.

Western Storm, which cost \$25 million, came to epitomize overall RTC contracting issues; it was discovered that sound contracting controls and procedures had not always been employed in hiring the contractors. In reports to Congress, the RTC's OIG and the GAO stated in general that systemic contracting flaws were identified in the following areas: (1) planning for major areas before awarding contracts, (2) ensuring fair and open competition in awarding contracts, (3) obtaining approval from the proper levels within the RTC organization, (4) adequately monitoring and overseeing contractors' charges, and (5) failing to have a system to provide information on contractor performance.<sup>16</sup> Western Storm was significant because it brought about heightened attention to overall weaknesses in the RTC's contracting process and resulted in major management initiatives to improve internal controls in this important area.

In 1992, as a result of Western Storm, the RTC reviewed the contracting process and made broad revisions to its contracting policies and procedures and more clearly articulated contractor oversight and administration responsibilities. In 1993, management had either implemented or submitted plans to implement every contracting-related recommendation that the OIG had made and had initiated a comprehensive training program on the fundamentals of contracting, contract administration, and the roles and responsibilities of the oversight manager.

Earlier, the RTC had implemented other contract management measures. In January 1991, it established the Office of Contractor Oversight and Surveillance to engage and direct independent public accounting firms to perform on-site reviews of contractors. Those reviews provided the RTC with assurance on the viability of the contractors' financial and administrative operations by addressing, in part, internal controls and cash management procedures, as well as compliance with RTC policies and procedures.

The FDIC responded to the challenge of asset management contracting by improving its procedures for overseeing contractors employed to service large pools of assets obtained from multi-million-dollar bank failures. To deal with that large volume of assets, the FDIC used a staff with extensive and specialized experience in the private sector to continuously review the actions of the contractors. Through the efforts of its on-site oversight staff, independent site visitation teams, and outside audits directed by the OIG, the FDIC ensured that contractors complied with the terms of the service agreements and that assets were managed in a manner that maximized the corporation's recovery.<sup>17</sup>

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16. OIG, *Semiannual Report to Congress*, October 1, 1991–March 31, 1992; OIG, *Western Region's Asset Stratification and Reconciliation Project*, February 2, 1992; GAO, *Summary of GAO Products on RTC*, July 1993; GAO, *Summary of RTC: Western Storm Investigation and Related Contracting Deficiencies*, August 6, 1992.

17. For more information on FDIC and RTC contracting, see Chapter 14, Asset Management Contracting.

### *Information Systems*

In the area of information systems, comprehensiveness, accuracy, reliability, and security were central control issues. The FDIC and the RTC needed reliable information about their inventory of assets and about the performance of the disposition efforts, claims administration, and other resolution and receivership initiatives. To a large extent, those concerns became contracting oversight issues because both agencies required private sector expertise for information management.

Large, complex, proprietary information systems could take years to develop and implement, but neither the RTC nor the FDIC could commit to such a timeframe and still meet their accelerated asset disposition schedules. Risks in the information systems area were compounded by the magnitude of the workload, the large number of different financial systems previously used by failed institutions whose data had to be converted to new systems, and the often abysmal quality of the records of the failed institutions. Furthermore, the agencies' decentralized office structure increased the risk that the development of management information systems would not be adequately coordinated.

The RTC recognized the need for a cash and management information system to transfer funds between the RTC and its asset management contractors and to provide a means to oversee and account for actions of its contract asset managers. In July 1990, the RTC contracted for the design, development, implementation, and operation of what was to become known as the Asset Manager System (AMS). Initial OIG and GAO audit reports to Congress criticized the development process and the design of the AMS, but the RTC initiated corrective action.<sup>18</sup> Beginning in 1992, the RTC implemented OIG recommendations by performing additional field-testing on AMS and producing documents for AMS, including adequate source code documentation, an installation plan, and operations and maintenance manuals.

The FDIC's asset management system, the Liquidation Asset Management Information System (LAMIS), began operation in 1984. At the time, the diversity and volume of assets acquired from failed institutions were less complex. With the growing crisis, however, LAMIS needed to be enhanced. Audits by the GAO in 1991 and 1993 and by the OIG in 1992 and 1993 found deficiencies in data integrity, response time and availability, effectiveness of system support activities, and the degree of system functionality in supporting liquidation goals and objectives.<sup>19</sup> The FDIC took actions to

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18. OIG, *Semiannual Report to Congress*, April 1992–September 1992; OIG, *Development and Implementation of the Asset Manager System*, September 24, 1992; GAO, *Corporate Strategy Needed to Improve Information Management* (GAO/IMTEC-92-38), March 1992; GAO-RTC, *Status of Asset Manager System* (GAO/IMTEC-92-34BR), March 5, 1992.

19. GAO, *Loan Sales Jeopardized by Systems and Other Internal Control Problems* (GAO/IMTEC-91-61), August 1991; GAO, *Asset Management System/Liquidation of Failed Bank Assets Not Adequately Supported by FDIC System* (GAO/IMTEC-93-8), February 1993; OIG/FDIC, *Information Systems Audit of LAMIS* (92-060) 1st quarter 1992; OIG/FDIC/IS, *Audit-Owned Real Estate System Processing* (93-131) 4th quarter 1993.

correct the deficiencies by implementing an extensive data integrity program, which was a broad-based effort. Program teams included managers and subject matter experts from several FDIC divisions. As a result of the program, the FDIC engaged private-sector contractors to service smaller valued assets, thus allowing FDIC staff to devote more time to improving data integrity for the larger assets. The program also allowed the FDIC to reassess required data elements, issue policy changes requiring account officers to certify the accuracy of required data elements on all assets in their portfolios, and establish quality assurance groups at the offices. The project initiatives resulted in a series of software program enhancements, which were installed by October 1996.

### *Asset Management and Disposition*

In the area of asset management and disposition, major liquidation functions and internal controls had to be coordinated to effectively dispose of assets acquired from the failed institutions. With such dramatic growth in the number and value of the assets at both the FDIC and the RTC, asset disposition internal controls were under constant revision. For example, during 1987, when 251 bank and S&L failures occurred, the FDIC and the FSLIC together held \$18 billion in assets at year end. At year-end 1989, with a combined total of 533 failures, the FDIC and the RTC (the FSLIC had been dissolved into the FDIC) together held \$81.2 billion in assets.

Significant issues in the area of asset management and disposition were related to national marketing initiatives, asset valuation methodologies, appraisal acquisition and evaluation, cash management practices, the recovery of tax benefits from assisted institutions, and the management and oversight of subsidiaries. Traditional asset disposition methods and markets were broadened with innovative programs such as securitizations and national auctions. Because some of the approaches were new, however, historical information was not available for designing controls and measuring performance.

Both agencies established internal oversight and review functions to monitor the financial results and compliance with established policies and procedures. To accomplish the goals of the policies and procedures, the RTC used such techniques as engaging private industry experts to develop disposition strategies for its large, sophisticated asset portfolios. The FDIC established procedures to increase the effectiveness of initiatives such as national bulk sales and the selling of assets at the time of resolution to accelerate the disposition of assets.<sup>20</sup>

The RTC also had devised a number of marketing strategies in an effort to quickly dispose of its assets. The Widely Marketed Portfolio Program was one such strategy. Under the program, which began in March 1991, a qualified investor could select assets from a list of assets that had been unsuccessfully offered through auctions or sealed bids.

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20. For more information, see Chapter 12, Evolution of the Asset Disposition Process, and Chapter 13, Auctions and Sealed Bids.

Minimum acceptable sales prices were established by the RTC, and the assets had to have been previously available to individual purchasers for at least six months. The first transaction attempted under the program was approved in July 1991 and involved the potential sale of hotels and office buildings worth up to \$500 million to Patriot American Investors, LP (Patriot).

OIG audits of the Patriot transaction found that although the RTC took several positive steps to implement the transaction and the portfolio sales program, concerns remained about the length of time and the amount of resources required to complete the transaction.<sup>21</sup> As of July 1992, after spending more than 12 months proposing more than 550 properties to Patriot, the RTC had executed sales contracts for only 30 properties and had agreed to sell 2 additional properties to Patriot, with the total transactions being worth approximately \$178 million. During the same time, the RTC had completed numerous bulk sales using other disposition methods that resulted in the disposition of more than \$3 billion in assets. Given its success with bulk sales, the efficiency and effectiveness of the Widely Marketed Portfolio Program compared to other sales techniques was questioned. As a result, the RTC elected not to conduct future sales under that program.

### The RTC's Transition to the FDIC

Upon enactment of the Completion Act on December 17, 1993, the statutory end of the RTC was slated for December 1995. The Completion Act required the FDIC and the RTC to establish an interagency task force to develop and implement appropriate internal controls to transfer the assets, personnel, and operations of the RTC to the FDIC. The task force was to be composed of FDIC and RTC personnel appointed by the FDIC chairman and the RTC CEO, respectively.

The task force, which was established in February 1994, created subgroups for each of the key areas and designated senior managers to coordinate planning for transition activities with responsible offices in each of the functional areas identified. The primary responsibility for coordinating the implementation of needed transition control activities of those groups was assigned to the Internal Control Policy Committee (ICPC), which was chaired by the CFOs of both agencies. The primary role of the ICPC was to ensure that internal controls employed during the transition were adequate to guard against financial loss, delays in the discharge of RTC responsibilities, or loss of public confidence. The ICPC also assumed a secondary responsibility for ensuring that the controls remained in place in the post-transition organization and that the FDIC operations that were receiving RTC activities accepted responsibility for the work that needed to be completed.

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21. OIG, *Semiannual Report to Congress*, April 1, 1992–September 30, 1992.

The task force was also directed to identify, evaluate, and resolve differences in FDIC and RTC operations. The task force was to determine the “best practices” and recommend which of the management, resolution, or asset disposition systems of the RTC should be preserved for use by the FDIC.

The ICPC required each functional task group to develop a management hierarchy responsible for planning and executing the transition at the office level and to develop a plan of action detailing the general methodology to be used for the transition. To ensure a successful transition, the ICPC established milestones to monitor progress.

The ICPC mission was completed after the post-transition validation of the effectiveness of the internal controls in June 1996, and the receipt of a certification letter from FDIC managers accepting responsibility for all matters and functions that had undergone transition. As a result, the transition was accomplished without any negative audit commentary from the OIG or the GAO.

## Conclusion

Properly designed and executed internal controls are usually transparent to program performance. The positive product of internal controls—the prevention of mistakes and problems—is not easily quantifiable and often goes unnoticed. The negative aspects of internal controls, however, are rarely missed. First, the “identification and response” (accountability for the problem and corrective action) aspects of internal controls are inherently unpleasant and have punitive connotations. Second, documentation of the internal control processes themselves often requires time- and labor-intensive procedures. In a climate of explosive growth and streamlined operations, basic control elements, such as segregation of duties, accuracy cross-checks, and authorization and verification procedures, are too easily dismissed as unnecessarily burdensome.

The experience of the FDIC and the RTC during the financial crisis of the 1980s and early 1990s demonstrated that internal controls, to be effective, must be vital, ongoing processes. Coordinated controls must be in place for each operational situation. As changes occur, management must be flexible and controls must be adapted accordingly to address the changing risk requirements.

The internal controls programs of the FDIC and the RTC evolved from a general environment of checks and balances with programs integrating self-evaluations, internal review and audit, and external audit to a flexible safety net of interrelated controls at all levels of operation. The agencies were able to rapidly expand and contract, or to decentralize and centralize, their operations to accomplish strategic program objectives without losing management control. The FDIC and the RTC succeeded in resolving the crisis without material management and financial problems that could have resulted in the loss of public confidence.

Robert Larsen, chairman of the RTC’s Audit Committee, stated in the *Wharton Real Estate Review*, that “the mostly scandal free administration of literally billions of taxpayer

dollars has gone, in most respects, unrecognized and unreported.”<sup>22</sup> In the same article, Larsen quoted John Robson, undersecretary of the Treasury in the Bush administration, who worked with the RTC in its early years, from *The Washington Post*:

At the very moment when a ferocious, national, political debate quite legitimately centers on the question of whether the federal government has failed in vast areas of its responsibilities, it is appropriate to celebrate a government program that has really worked. Perhaps it is too much to expect that the RTC and its Oversight Board be commended for effectively and rapidly cleaning up a mess that might have been avoided in the first place, and that cost the taxpayer billions to fix. But it is hard to deny that the overall performance of these agencies was terrific.

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22. Robert C. Larsen, “The RTC: Dispelling the Myths,” *Wharton Real Estate Review*, vol. 1, no. 1 (Spring 1997).

